



Restructuring of indebtedness: Spanish tax points

This briefing sets out the key Spanish corporate income tax issues in respect of debt restructurings. In summary, debtors may face material tax consequences if and when third party debt is replaced by a related party debt, if the debt is totally or partially waived or refinanced, or if it is converted into equity. If any changes are being made to the structure of corporate debt, such as debt-for-debt exchange, debt-for-equity exchange, debt waiver, debt buy-back or amendment of terms and conditions, then it is important to look at the possible tax consequences early. Here we show how careful planning can help both debtors and creditors make restructuring decisions that are sound from a tax perspective.

Introduction

This briefing summarises key Spanish tax points related to restructuring of indebtedness.

A key tax principle is that tax follows accounting. Therefore the tax impact will vary according to the way the debt is accounted for (amortised cost or fair value) or if the debtor has entered into derivatives to hedge the exposure of the debt to interest rate changes.

In this regard, please note that the Generally Accepted Accounting Principles (GAAP) relating to Spanish banks are different from the GAAP applicable to Spanish companies, so this briefing comments generally on the tax consequences. There may also be issues to do with the nature of the debtor that create some tax differences.

In this briefing, we concentrate on plain-vanilla debt, which is debt for legal and accounting purposes. However, experience shows that debtors often face restructuring on more complex instruments, such as hybrids (essentially long-term subordinated debt with long maturity and with profit-sharing features) or a mix of debt and equity.

Generally speaking, expenses arising from external financing (regardless of the type of activity in which the loan is invested) and recorded for accounting purposes would be considered as deductible for tax purposes.

Interest expenses are also generally deductible on debts between related parties. In this case, thin-capitalisation and valuation rules would need to be taken into account

in assessing how much of the expenses are tax deductible. Although there are no restrictions on the duration of the indebtedness, in related-party situations the Spanish tax authorities may try to re-characterise certain transactions if the parties have intended to provide equity funds in the form of a debt.

Debtor side

Amendment of the terms and conditions

Amendment of the terms and conditions (T&Cs) of a debt instrument based on negotiations between creditor and debtor could have an effect on accounting, if those conditions can be considered as substantially different for accounting purposes. If the 'new' debt has substantially different conditions from the 'old' debt (worth 10 per cent or more), the old debt will be released from an accounting and tax point of view and replaced by the new debt.

There are no specific tax rules relating to T&Cs, so tax will follow accounting. Amending T&Cs can result in a current profit or loss, which would generally be taxable or deductible. There may also be a difference (or an increased difference) between the cash flows on the interest payments and the amounts that are deductible. This may have a bearing on withholding tax.

A reduction of the nominal amount of the outstanding debt would in principle lead to a profit being recognised for tax purposes. The accounting value of the new debt would also have an effect on the thin-capitalisation ratio.

Apart from the above, assuming that the debtor and creditor have negotiated such changes on an 'at-arm's-length' basis, amendments to a debt instrument's T&Cs should not lead to material tax consequences. In particular, and by way of example:

- deferral of interest payments or agreement to capitalise them should not negatively affect deductibility in principle. This is because interest is normally deducted on an accrual basis; however, the amount of interest could change under new T&Cs;
- conversion into a subordinated debt, adding additional collateral provided by the debtor or even a third party, does not alter the fact that the loan is considered external financing and therefore any interest paid continues to be tax deductible; if the collateral is provided by a related party, transfer pricing rules will be applicable;
- linking payment of interest to the debtor realising profits should not itself affect the debt instrument's tax position; however, it could cause the debt to be divided into a loan component and a derivative;
- an extension of the maturity term should not by itself affect the debt instrument's tax position, but may affect its valuation; and
- if covenants have been breached and the creditor agrees not to exercise its right to demand full repayment but to renegotiate, there is no obstacle to the tax deductibility of any higher interest rate agreed because of the debt's higher risk profile.

Debt-for-debt exchange

As mentioned above, if a 'new' debt has substantially different conditions from the 'old' debt, the old debt will be released, from an accounting and tax point of view, and replaced by the new debt. Otherwise, if the conditions are not substantially different (less than 10 per cent in value), then the old debt will be kept for accounting and tax purposes, and the adjustment will be made through the annual profit and loss account.

So a debt-for-debt exchange can result in a current profit or loss, which would generally be taxable or deductible.

The debt-for-debt exchange may happen in the course of a negotiation with the creditors or in the course of an insolvency proceeding. This makes little difference for Spanish tax purposes, because the consequences are

similar. However, timing when the profit arises if part of the debt is released is relevant because it will immediately trigger a taxable event for the debtor.

Debt-for-equity exchange

In general, operations to convert debt into equity will not generate accounting income because the value of debt (principal plus accrued interest) is substituted by an equivalent value amount. In certain cases, a difference arises as a result of the way the debt has been accounted for (amortised cost or fair value) by the debtor, although in principle it should not affect the profit and loss account but may affect the equity of the debtor.

However, capital tax would be payable for the increase of capital at the standard 1 per cent rate.

Debt waiver

Although debatable, a partial or full waiver of the principal amount of a debt instrument (and/or accrued interest) would lead to a taxable profit for the debtor equivalent to the amount cancelled. This is generally regarded as a gratuity. There are ways to structure a debt waiver through equity, to manage this impact in a more neutral way.

Debt buy-back

A buy-back of debt by the debtor at a discount to the principal amount would normally lead to taxable profit on the discount for the debtor. However, a debt buy-back by a party related to the debtor does not automatically trigger an obligation to assess a profit as accruing to the debtor. The accounting profit, however, can still be shown on the consolidated accounting statements.

If the debt is bought back by a related party, the second relevant issue is the recognition for tax purposes of the discount as additional income. In other words, the deferred taxation of the discount. This will depend on the nature of the debt purchased, because the situation would be different in a case involving perpetual bonds, for example. If the taxation and the deferred taxation are dealt with properly, the amount of the accounting profits will be larger, because they will not be reduced by a tax debt.

Acquisition of debt by a related party leads to the triggering of thin-capitalisation rules.

Creditor side

If a financially distressed debtor is unable to repay debt under the form of a loan, the creditor will be allowed to recognise a tax-deductible devaluation provision only if at least one of the following conditions is met:

- six months have elapsed since the debt became due;
- the debtor is declared bankrupt;
- the debtor is being prosecuted for concealment of assets; and
- the debts have been judicially claimed or are subject to judicial or arbitration proceedings.

In addition, there are specific rules establishing when the devaluation provision shall not be considered tax deductible. These are generally related to guaranteed debt or related-party debt. In any case, if after the devaluation provision has been recorded and deducted for tax purposes, the debtor pays the debt or the situation that allowed the provision to be made changes, a taxable income will be recognised.

Impairment of the loan due to an increase in the credit risk of the debtors is not deductible.

On the other hand, creditors should include accrued interest in their taxable income even if the interest has not been paid. There may be ways to structure coupon zero loans or bonds to avoid withholding tax until the loan is paid. Mention should be made of 'debt by way of listed bonds' and the different tax treatment on the interest payment if compared with standard debt. In principle, interest paid on listed bonds should be exempt from Spanish withholding tax even if held by residents in tax havens.

Amending the T&Cs shall not prevent the creditor from including the accrued interest in its taxable income but may affect the devaluation provision's tax deductibility if the debtor offers new guarantees.

As mentioned above, a debt waiver is generally considered as a gratuity, so the loss resulting from waiving the debt is non-deductible for tax purposes. This may create excess taxation, because the profit is taxable in the hands of the debtor.

Capital adequacy

Finally, attention should also be given to the effect that the restructuring may have on the debtor's capital

adequacy requirements, as a result of the accounting effects of the debt restructuring process. There are ways to structure the process in a neutral way from a capital adequacy point of view.

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